

**Miroslav Majtán**

**Peter Šinský**

Ekonomická Univerzita v Bratislave

# **INTERNALISATION OF SMES**

## **– SOURCE OF COMPETITIVE ADVANTAGE**

### **Introduction**

Small and medium enterprises have an important position in each developed economy. Their existence is irreplaceable and in accordance with the interests of the market economy. The mutual coupling of national economies and the internationalization of economic processes increasingly influence small and medium enterprises, in addition to major companies.

The subject of this report is business internationalization. The aim is to define the position and approach to the formation of clusters as tools to increase innovative performance based on the analysis of the current state of small and medium business practices and their innovative potential in Slovakia.

### **1. Importance of SMEs in the Slovak Economy**

Small and medium enterprises are an integral part of each market economy. They suitably supplement large companies, because they usually focus on production that wouldn't be effective at a large volume, and contribute to increased competitiveness, as well as the formation of new job opportunities. They may also act as a catalyst for the restructuring, innovation, creation of capital and the spreading of a business spirit.

The operation of SMEs is associated with several advantages and disadvantages. They are especially known for their adaptability and flexibility, because they don't have extensive frozen assets, allowing them to quickly adjust capacity and switch to a new line of activities. A significant advantage of these companies is the direct contact with customers, allowing them to quickly identify and respond to current market needs.

From the organizational perspective, small and medium enterprises (SMEs) are typical for their simple and clear organizational structure with direct management and control. The employee potential is focused more universally than in the case of large companies, allowing them to adjust to any significant changes in the company.

However, the size and flexibility of SMEs has several disadvantages as well. In the production area, the insufficient utilization of technical and technological capacities may lead to overpriced products, which forces them to focus on high quality and a narrow product range. Concerning sales, the limited numbers of customers, strong competition, lack of funds for advertising and promotion, etc., are also a disadvantage.

In some smaller companies, the only source of funding is from self-financing, which is often insufficient to cover the increasing financial needs in a company. When developing or trying to innovate the business activity, they encounter the problem of lack of capital. Due to the risk rate and lack of guarantees, it is considerably difficult to obtain loans.

Despite some other problematic areas, the significance of SMEs in the overall structure of the Slovak economy is indisputable. In 2012, a total number of 140,120 SME entities were operating in Slovakia, representing 99.54% share of all enterprises. They employed 4.4% of the active labour force and the GDP level accounted for 55.6%.

It is true that 56% of SMEs don't survive the first five years of operation, while one of the reasons is the limited access to finances.

A similar current situation in small and medium enterprises exists in Germany, one of our most important business partners within the EU. The crucial difference is only in defining the SMEs category: in Germany, small and medium enterprises are those with less than 500 employees and/or annual turnover of less than 50 million Euros.

According to the IfM institute, 99.9% of all companies in Germany belonged to small and medium enterprises in 2010, and therefore they are considered the backbone of the German economy. These companies form 36.9% of the total achieved turnover in the German economy and employ 60.0% of all employees who are required to contribute to the social insurance system<sup>1</sup>.

Even at the European level, SMEs are the cornerstone of the European economy. With a total number of 20.7 million companies, they form more than

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<sup>1</sup> M. Majtán, P. Šinský: The Selection of an Appropriate Type of Financing for Small and Medium Enterprises. VŠB – Technical University of Ostrava, Faculty of Economics, Finance Department. Ostrava 2013, s. 7.

98% of the total amount of all companies and employ over 87 million people. The largest portion of SMEs (99.2%) is formed by the smallest companies with less than ten employees. It is estimated that SMEs create approximately 67% of all of job positions and account for 58% of the total gross value added<sup>2</sup>.

The long-term development of small and medium enterprises isn't possible without a thorough analysis of their financial management. Their financing in theory is not very elaborated and is probably related to their interdisciplinarity. Their essence lies in the acquisition of finances so that the company can realize investments. However, the capital is such an important source that it is often not available in the required amount to finance all necessary investments.

The term financing is commonly understood as all activities ensuring the coverage of the necessary capital. The sources for capital acquisition may be the company's own or borrowed capital (debt financing), but also resources from re-directed flows within the company (internal financing).

Several surveys concerning the financing of small and medium enterprises carried out at home and abroad<sup>3</sup> state, that without indebtedness, the companies are not able to realize the necessary investments, when the preferred form is financing from its own resources (internal financing from profits, reserves, and financial flows). In the case of necessary debt capital, the most important form of debt financing is still the classic bank loan (loans and overdrafts). A lease is also commonly used, but it has a smaller strategic importance.

In terms of corporate lending, loans are distinguished according to their maturity into three types:

- short-term loan (maturity within 1 year),
- medium-term loan (maturity from 1 to 4 years)
- long-term loan with maturity of 4 years or more.

The repayability of financing must be scheduled to match the economic lifetime of the given item's investment assets. If the loan repayment period is determined correctly, the liquidity risk can be avoided.

Short-term forms of financing are mainly used to finance current assets under the Golden Rule of Finance. These forms include: overdrafts, loans in the financial market, supplier credit, factoring, advance payments.

Medium and long-term loans are usually used to finance fixed assets. SMEs have access to the following forms of medium and long-term financing: loans, leasing, means of support from public funds, and some other forms of medium

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<sup>2</sup> OECD Science, Technology and Industry Outlook 2012. OECD Publishing, 2013, s. 43.

<sup>3</sup> E. Szabo, N. Jankelová: Podnikateľské rozhodovanie. (Corporate Decision-Making) EKONÓM Publishing, Bratislava 2007, s. 29.

and long-term financing that can be marked as alternative forms of funding and are related to the introduction of the BASEL III rules. However, these make the bank loans more costly. They mainly include Private Equity and an internet platform for financing needs. These forms, as well as other newly-established ones are only used sporadically in Slovakia.

An important impetus for the development of SMEs in Europe may also include the support of these entities by the European Union. Besides others, the European Parliament approved two important programs for the support of small and medium enterprises in 2013. A better approach to financing through loan guarantees and venture capital should be brought by the first EU program focused on SME, called COSME. The expected budget is 2.3 billion Euros, primarily directed to support competitiveness and the internationalization of companies on the internal market and third countries, as well as the support of small entrepreneurs. A total amount of 1.4 billion Euros will be used to strengthen national financial schemes for loans and the venture capital. The guarantee instrument will guarantee for loans up to 150,000 Euros. This help could be utilized by 330,000 companies.

The COSME program is closely related to the second, larger research program, Horizon 2020. They will support all types of SMEs. COSME will focus on their growth and Horizon 2020 on start-ups.

For a 7-year period, Horizon 2020 has an approved budget of 80 billion Euros. As one of the few, it recorded an almost 30% increase compared to the previous period. It's a new type of program based on three pillars – excellent science (32% of the budget), industrial leadership (22%), and societal challenges (39%).

It integrates all the support of research and innovations, which will be subject to individual rules, leading to a significant reduction of administrative burdens. It will finance everything from the slightest science to market-oriented innovations. Overall, 11% of the budget should be utilized for small and medium enterprises.

## **2. Innovative Potential of SMEs in Slovakia**

The role of SMEs in the innovation process and their overall contribution to strengthening economy innovativeness are subject to several studies. These also evaluate the factors contributing to the increased innovativeness of SMEs. Some arguments can be summarized as follows:

1. SMEs are capable of innovations thanks to the simple organizational structure and greater willingness to take risks.

2. The studies disagree as to whether SMEs are generally more innovative than large companies. However, the general comparison may not be accurate – the SMEs category contains both companies with virtually non-existing innovative activities and technological leaders bringing radical innovations.

3. Based on empiricism, it can be concluded that SMEs are engaged in technological innovations in a large number of sectors and represent a significant source of employment and productivity growth<sup>4</sup>.

According to some authors, small enterprises and especially start-ups play a different role in the innovative process than large enterprises. Baumol<sup>5</sup> distinguishes two innovation types – breakthroughs and incremental improvements. Breakthrough innovations bring discontinuity in terms of technology, organizational processes, marketing, etc. In contrast, incremental innovations are small improvements of existing products and processes. One example may be the achieved result through the managing methods of kaizen and re-engineering. The first group is less numerous but its individual impact on productivity, growth, and unemployment is significant. The individual impact of incremental innovations is small, but cumulatively they have major importance. According to Baumol, most breakthrough innovations currently come from small enterprises and start-ups. Major enterprises are dominant creators of incremental innovations.

In terms of the development of SMEs, especially those subcategories that are most commonly involved in the innovative processes, Slovakia lags behind the EU average. After a period of continuing growth from 2002 to 2008, the development of SMEs recorded several negative changes in the last four years, which resulted in dampening the business activities of SMEs, limited expansion, and withdrawal from the market. Between 2008 and 2012, the number of SMEs in the medium-sized enterprises category (50 to 249 employees) decreased by 15% and the number of small enterprises (10 to 49 employees) by 46%. The number of sole traders decreased within the same period by 33,266.

This manifested itself by a significant increase of micro-enterprises at the expense of larger-sized SMEs categories. In 2012, only 14,339 companies outside the micro-enterprise category operated in Slovakia, i.e. those with more

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<sup>4</sup> Z. Tučeková, R. Geist: Inovačný potenciál slovenských MSP. (Innovative Potential of Slovak SMEs.) EuroPolicy Civic Association in Collaboration with the Ministry of Foreign and European Affairs of the Slovak Republic 2013, s. 6.

<sup>5</sup> W.J. Baumol: The Free-market Innovation Machine: Analyzing the Growth Miracle of Capitalism. Princeton University Press, 2002, s. 87.

than 10 employees and an annual turnover of more than 2 million Euros, representing a 51% decrease compared to 2008. These changes subsequently lead to the decrease in production, profitability, and competitiveness of SMEs and jeopardize their sustainability in the market. This process is also reflected in employment, with micro-companies forming 45.6% of job positions in the Slovak corporate economy (data from 2012), being 50% more than the EU average in this category (29.9%, data from 2010). SMEs also achieve a lower share of added value than the EU average (57.5%, data from 2010). The number of companies operating in industrial sectors with a high-technology and medium-high technology level (HTMHT), as well as knowledge-intensive services (KIS) in Slovakia is lower than the European average. According to the data of the National Agency for the Development of Small and Medium Enterprises, processed according to the statistical bases of the Slovak Statistical Office, to 30 June 2013, only 3% of the total number of SMEs (legal entities) registered in the industrial production sector operated in the production sector with a high-technology level (HT) and 14% in the production sector with a medium-high-technology level (MHT). In the case of SMEs – natural entities (sole traders), it was only 0.8% in the HT sector, and 5.3% in the MHT sector. In the service sector, 35.1% of SMEs – legal entities operated in the knowledge-intensive services (KIS), and 27.1% SMEs – natural entities (sole traders) registered in the service sector. In the overall European average, the share of SMEs on HTMHT and KIS is 26% (EU-27).

This situation manifests itself in the overall economic state as well. Based on the Global Competitiveness Report 2012 – 2013, published by the World Economic Forum (WEF), Slovakia occupied 71st place in the ranking of 144 assessed countries – we became the third least competitive economy in the Union after Romania (78th place), and Greece (96th). This was mainly due to our bad results in the innovations sector: in the twelfth pillar, through which WEF evaluates the overall economic state, we ended up in the 96th position.

The low innovativeness rate of SMEs in Slovakia is also concluded by the Organization for Economic Co-operation and Development (OECD). In the report from 2012<sup>6</sup>, the causes are primarily seen in the underdeveloped research activities of SMEs. The research and development results undertaken in the private sector have long been below the OECD average. This fact corresponds with the downward trend in private investments in R&D, currently at 0.27% of GDP (2010).

According to OECD, the Slovak economy is trying to compete through cheap labor force rather than developed technologies (115th place). At the same time, Slovak producers have little effect on international distribution (126th

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<sup>6</sup> OECD Science. Op. cit., s. 43.

place). The inefficient structure of public expenditure (122th place) and insufficient government interest in the procurement of technologically advanced products (127th place) have a negative effect. Other significant negatives are the weak cooperation between universities and companies (100th place), insufficient company expenses on R&D (85th place), the low quality of R&D institutions (90th place), the capacity for innovations<sup>7</sup> (88th place), and availability of scientists and researchers (89th place).

Slovakia's lag in the development of innovative clusters, the low quality of graduates required for positions in sectors with a high added value, and the mismatch between the offer of qualifications with the private sector's requirements, contribute to the poor state.

Based on international comparisons and evaluations, it can be concluded that Slovakia's lag in this area is caused mainly due to the combination of these influences:

1. Insufficient connection of SMEs with a broader innovation environment, also caused by badly set infrastructure.
2. Lack of public infrastructure to support innovations, specifically in SMEs.
3. Lack of instruments to fund the growth of innovative companies in the critical early and growth stages.

One of the possible factors to increase innovativeness are the internationalization processes. In the case of innovative SMEs, the condition of high growth is often the ability to succeed on international markets. Especially for small national economies, such as Slovak, the customers and business partners are often located abroad. Public policy should therefore provide tools to strengthen the internationalization of SMEs.

### **3. Clusters as a Tool to Increase Innovation Performance**

Clusters represent a geographic concentration of mutually connected companies, supplier chain organizations, service providers, universities, and scientific research institutions generally operating in one sector. Currently the micro-economic factors increasing the prosperity of regions are considered important. In addition, they may help increase the flow of direct foreign investments.

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<sup>7</sup> In the "capacity for innovations" indicator, their level is assessed from range of 1-7. Value 1 means that the country procures technologies exclusively through licenses or by imitating foreign companies, while 7 means that technologies are procured from its own research and the development of new products and services. Slovakia reached a value of 2.6 (OECD average is 3.2).

According to the nature of creation, two cluster types are known:

1. Clusters based on the value chain – characteristic for a chain of supplier bonds with a linear connection between them from raw materials to the final product. The support of this cluster type is focused on specific needs in the sector.

2. Clusters based on competences – these focus on a specific area of technical skills or competences in a region, such as research or education capabilities. These are not the crucial supply relations within one sector, but rather the application of the knowledge itself, often across very different activities, such as IT/IS.

An important contribution of clusters is that they form an environment suitable for innovations and knowledge creation. That is why regions with strong clusters are considered innovative leaders, while globalization further deepens these trends. A cluster usually acts as an intermediary between individual cluster members and stimulates the collaboration between enterprises and the external environment.

The advantages of building clusters include:

1. Increased productivity (through specialized inputs, access to innovations and products)

2. Faster innovation activity by strengthening competitiveness.

3. Creation of new companies and long-term corporate dynamics.

4. Inflow of new foreign investment opportunities.

A participation in a prospering cluster means several significant advantages for enterprises:

1. An environment reducing the risk associated with innovations and simplifies this process.

2. Access to customers and a greater range of business opportunities.

3. Wider range of specialized services and infrastructure relevant to the given industrial sector.

4. Easier and faster access to knowledge and new ideas.

5. Direct access to a wide range of suppliers with the potential for lower transport, supply, and transaction costs.

6. Ability to invest in vocational skills relevant for the value chains in the region.

The clusters are also linked to certain risks. Due to their high specialization, there's a higher potential vulnerability in the case of market fluctuations, such as demand shocks, technological shifts, etc.

In Slovakia there's no cluster formed on the central government's initiative. The creation of clusters is an example of bottom-up initiative. Some of them are more oriented on project and international activities, in others it is an activity closely focused on its members that predominates.



All clusters need an improvement of their innovation infrastructure and access to innovation instruments for their development. Currently, Regional Innovation Centers (RIC) are being established in every region. Their focus is determined on regional innovation strategies. For example, the Trnava region will focus on the automobile, electrotechnical, and energy industries. RIS should supplement the innovation infrastructure of regional participants in this field of action with regard to the needs of entrepreneurs, and participate in the solutions to research and development projects in collaboration with universities.

The European Commission's effort is particularly to stimulate the development of cross-border clusters and strengthen the powerful European clusters through trans-European cluster policies. The key feature of successful cluster initiatives is the sharing of strategic information. European initiatives for the support of clusters should complement national and regional activities as much as possible in order to better exploit the synergies and support the specific priorities of individual countries.

There is no universal recipe for an excellent cluster that would suit all regions, but there is enough information and experience from functioning regional clusters in the world, from which one can choose according to the needs and requirements of the specific region. Generally, it may be concluded that most clusters need flexible support for three to five years, especially at the beginning of their operation. It should flexibly respond to the changing economic and technological environment in which the cluster associations operate<sup>8</sup>.

The first cluster associations in Slovakia were mainly created from the initiative of regional and town governments, whose approach to the support of innovations varies considerably. In order to support the activity of clusters from the government, the Union of Slovak Clusters was established in August 2010. Its task is to be a partner for communication concerning cluster policy and clustering itself not only on the national but also international level. It currently has ten members and has been registering other acceding clusters.

For comparison, in the Czech Republic, the National Cluster Strategy was approved already in 2005, while its main instrument to fulfill the cluster strategy in 2005 to 2008 was the Operational Program Industry and Enterprise's "CLUSTERS" program.

The state of cluster policies among EU member countries varies considerably. Some countries have national policies (France, Luxembourg, Latvia, Lithuania, Portugal, the Czech Republic, Greece, Poland, Romania, Bulgaria,

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<sup>8</sup> T. Lämmer-Gamp: Clusters are Individuals. Creating Economic Growth through Cluster Policies for Cluster Management Excellence. 2011. <http://en.fi.dk/publications/2011/cluster-are-individuals-creating-economic-growth-through-cluster-policies-for-cluster-management-excellence> (12.3.2013).

Finland), others regional (Belgium), national frameworks for regional policy (Austria, Germany, Hungary, Italy, Sweden, Great Britain, Spain), or a combination of various associated initiatives (Estonia, Denmark, Ireland, the Netherlands, Slovakia, Cyprus, Slovenia and Malta).

Over the last two decades, the main emphasis in Europe was placed on the support of new cluster creation in order to facilitate cooperation between companies in subcontracting chains with each other, and subsequently with universities and R&D institutions. Today's task is, however, to deal with the advanced levels of the mentioned cooperation between clusters from various regions and sectors which thus become a means to support SME internationalization, as well as for the strategic development of transnational cluster cooperation on the European markets and beyond Europe.

It goes without saying that the internationalization of clusters and affiliate subjects should not be a random phenomenon, and it should be preceded by the drafting of this process' strategies. The importance of clusters' strategic orientation on international networking enables the following advantages:

- networks and clusters with the internationalization strategy are more successful on the international level than those without a strategy,
- efficient cluster management is able to systematically reduce potential internationalization obstacles and create conditions for companies united in the networks and clusters to engage in international cooperation,
- the internationalization of cluster programs is important for the permanent growth of the cluster as an internationally active entity, able to support fruitful cooperation between its members and relevant organizations in other countries and regions,
- the international focus of regional networks and clusters allows affiliate companies to reach foreign target markets easier and successfully, thus improving business activities,
- the positive impact on business is significantly higher in cases when a network or cluster are responsible for internationalization, than when the companies are responsible for it themselves.

Especially in the initial stages, small companies often don't have the resources to track various types of help and the opportunities to join international forms of cooperation provided by the EU programs. These companies are not always able to fully assess the innovative and market potential of their products or explore new business opportunities, especially in areas they don't know well. This gap should be filled in by local clusters whose role would be to mediate the stated options to small and medium enterprises and connect entities that would have mutual benefits from the cooperation.

In order for clusters to be ready to enter into international cooperation and become a mediator of new information, projects, supplier-customer contacts, and joint partnerships for their members, being primarily SMEs, they must reduce considerable activity. A cluster in the process of its activity's internationalization should go through the following steps<sup>9</sup>:

1. Consider the objective to be achieved through international cooperation (access to new knowledge, new markets, infrastructure, laboratories, new partners for cooperation, mutual development, increase of its own credit, increase of competitiveness and export performance in key businesses, etc).

2. Assess its own readiness (enough active members – achieving a critical mass of members, level of local cooperation, financial resources, employees proficient in the language and professionally, etc.)

3. Identify opportunities (potential markets, saving the transport costs of cluster members, access to innovative partner infrastructures missing on the local level, utilization of results arising from common projects, etc.).

4. Develop a strategy and action plan for internationalization (potential partner countries strategically suitable for cooperation, activities, outcomes, budget, promotion, compliance with regional, national, and European strategies, and the option of influencing policies and programs in member countries, etc.).

5. Hold trainings of cluster managers (orientation in options and procedures of international cooperation, trainings of managerial and professional language skills and corporate culture, orientation in the system of structural, community, and cross-border EU grant programs).

6. Identify partners (focus on win-win partnerships, entities with a similar objective, verification of existing networks – general, sectoral, territorial, global, and if relevant, consider joining them, etc.).

7. Prepare joint projects reflecting the needs of cluster members (specify the project aim, activities, expected results, budget, method of promoting outcomes and their possible commercialization, etc.).

8. Implement projects (operational activity fulfillment, monitoring of cluster's cash-flow, progress monitoring and implementation of outcomes, flexibility in changing estimated implementation conditions, etc.).

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<sup>9</sup> V. Vančová: Návrh podpory inovačného procesu v priemyselných podnikoch prostredníctvom medzinárodnej spolupráce. (Proposal for Innovative Process Support in Industrial Enterprises through International Cooperation). Dissertation. Slovak University of Technology, Faculty of Materials Science and Technology in Trnava, Trnava 2012, s. 108.

9. Evaluate the benefits of joint projects (monitoring based on qualitative and quantitative indicators, impact monitoring, and exploitation of project results).

10. Establish a sustainable cooperation method (professional and efficient management, self-financing, priority selection of partners interested in permanent cooperation and not only ad-hoc projects, in the case of an existing network with a similar aim – joining it, etc.).

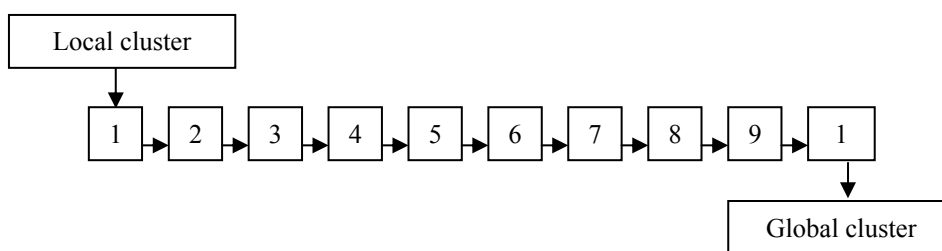


Fig. 1. Flowchart of the cluster internationalization process

Source: Our own processing based on the source [11].

In terms of clusters, it is most efficient to utilize the already existing European Union initiatives in the preparation stage of transnational cooperation. The advantage of these initiatives is that they help form the European innovation space and motivate the concerned innovative parties from various member countries to cooperation.

In addition to this traditional approach to networking, a more active approach to transnational cooperation through promotional policies on other levels is necessary, both national and regional. The result should be a situation where the network is not the objective itself, but rather a means to solve specific problems and challenges.

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### Summary

Small and medium enterprises (SMEs) represent a substantial impact on the business environment. One of its strengths is its potential for innovation. The article deals with the development opportunities of innovation activities of SMEs at the national and international level.